Supreme Court, U.S.
FILED
APR 10 1992
OFFICE OF THE CLERK

(22)

No. 91-615

In The

Supreme Court of the United States

October Term, 1991

ALLIED-SIGNAL, INC., as successor-in-interest to The Bendix Corporation,

Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,

Respondent.

On Writ Of Certiorari To The Supreme Court of New Jersey

BRIEF FOR AMERICAN GENERAL CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

ROY E. CRAWFORD
Counsel of Record
RUSSELL D. UZES
CHRISTINE A. DEATON
BROBECK, PHLEGER & HARRISON
One Market Plaza
Spear Street Tower
San Francisco, CA 94105
(415) 442-0900

KAREN A. BAIN
AMERICAN GENERAL CORPORATION
2929 Allen Parkway
Houston, TX 77019

Counsel for Amicus Curiae

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

19

QUESTIONS PRESENTED

1. Should the Court overrule *ASARCO v. Idaho State Tax Commission*, 458 U.S. 307 (1982), and *F.W. Woolworth Co. v. Taxation & Revenue Department*, 458 U.S. 354 (1982)?

2. If *ASARCO* and *Woolworth* were overruled, should the decision apply retroactively?

3. If *ASARCO* and *Woolworth* were overruled, what constitutional principles should govern state taxation of corporations doing business in several states?

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

CASES

STATUTES AND REGULATIONS

TABLE OF AUTHORITIES – Continued

INTEREST OF AMICUS

American General Corporation hereby respectfully files this Amicus Curiae Brief in Support of Petitioner Allied-Signal Inc. American General has received the consent of both parties to file the Amicus brief.

American General Corporation is the Texas-based parent of a large affiliated group of corporations. The affiliated group conducts an insurance business and a financial services and consumer lending business.

The decision in this case could have a profound influence on a current dispute between American General Corporation and the California Franchise Tax Board. During the early 1980's, several members of the American General affiliated group operated a mutual fund management business in California. American General Corporation, the mutual fund companies and other non-insurance corporations joined together and filed a single combined report each year in California (the "mutual fund combined report"), and paid a tax to California based on the amount of mutual fund income apportioned to California by a three-factor apportionment formula. California proposes to treat the dividends received by American General Corporation from its insurance subsidiaries, *which were not included in the mutual fund combined report*, as mutual fund apportionable income. California proposes to apportion the dividend income with reference to the apportionment factors of the mutual fund management business. American General is contesting this treatment.

This Brief addresses the questions raised by the Court in its March 11, 1992 Order from the perspective of a multi-state taxpayer that files returns in combined

reporting states such as California. The Brief proposes a rule of apportionability similar to the rule contained in the Uniform Division of Income for Tax Purposes Act (UDITPA), 7A Uniform Laws Annotated 331 (1985), and discusses why the Court should reject the standard of full apportionability advanced by Respondent (New Jersey) during oral argument.

ARGUMENT

The Court should adopt a rule of apportionability that would allow a state to tax income related to an intangible asset only if the asset constitutes an integral part of the taxpayer's unitary business. The Court should reject New Jersey's proposal to empower a state to apportion and tax the *entire* net income of a corporation. New Jersey's proposed standard would merely shift the due process inquiry to the more ephemeral issue of fair apportionment.

I. The Court Should Clarify Its Decisions in *ASARCO* and *Woolworth* to Treat Income Generated by an Intangible Asset as Apportionable Income if the Asset Constitutes an Integral Part of the Taxpayer's Unitary Business.

State courts and administrative tribunals have applied *ASARCO v. Idaho State Tax Commission*, 458 U.S. 307 (1982), and *F.W. Woolworth Co. v. Taxation and Revenue*

Department, 458 U.S. 354 (1982), inconsistently.[1] For the benefit of both taxpayers and taxing authorities, the Court should clarify its decisions in *ASARCO* and *Woolworth* to diminish the importance of operational control and adopt a standard of apportionability similar to the standard in UDITPA.

A. Operational Control Should Not Be a Prerequisite to Apportionability.

The concept of a unitary business relationship arises in two distinct contexts. The first is whether an item of income is sufficiently related to the business conducted in a state by a corporation to permit a state to tax that income. *See, e.g., Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980). The second is whether the business conducted by a corporation is part of a single or unitary business conducted by other corporations so that a state may apportion the combined income of the group. *See, e.g., Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

The Court in *ASARCO* blurred this distinction. The parties in *ASARCO* disputed whether a minimal connection existed between ASARCO's dividend income and ASARCO's activities in Idaho. In resolving this dispute, the Court focused on ASARCO's lack of operational control over its foreign affiliates. The existence of operational control is only significant, however, for purposes of

[1] *See* Roy E. Crawford and Russell D. Uzes, *The Distinction Between Business and Nonbusiness Income*, The State & Local Tax Portfolio Series 665-683 (Corporate Tax Publishers, Inc. 1991).

determining whether two or more corporations are engaged in a unitary business and should file a combined report in a combined reporting state.[2]

There is no reason why operational control over an affiliate should determine whether an item of income is sufficiently connected to the activities of the taxpayer in the taxing state. The Court in *Mobil* recognized that an intangible asset such as a minority stock interest in an affiliate can advance the unitary business of the owner.[3] For a vertically integrated business, a minority-owned affiliate can provide an important source of supply for the owner or an assured market for the owner's product. For a horizontally owned business, an affiliate can serve as a toehold into a new geographic market for the investor, with the investor benefitting from new information and access to untapped markets.

---

[2] Only commonly owned and controlled corporations file a combined report because a combined report can change the tax liability of each corporation included in the report in a dramatic fashion. In a combined report, each member engaged in business in the state is attributed a share of the combined income. Thus, a member with a loss on a separate return basis may actually be attributed positive taxable income if the overall combined group is profitable. A sense of fairness limits the application of combined reports, therefore, to commonly owned and controlled corporations.

[3] The Court was clearly correct in *Mobil* when it held that Vermont could tax the dividend income Mobil received from affiliates like the 10%-owned Aramco. Mobil undoubtedly participated in Aramco because Aramco advanced Mobil's unitary petroleum business substantially. Mobil did not have operational control over Aramco, however, with only a 10% ownership interest.

B. The *Mobil* Decision Reflects the Proper Way to Analyze Dividend and Capital Gain Income.

The Court in *Mobil* stated that the "linchpin of apportionability in the field of state income taxation is the unitary business principle." 445 U.S. at 439. All assets constituting an integral part of the taxpayer's unitary business should generate apportionable income.[4] The Court implicitly applied this standard in *Mobil* when it characterized the dividends received by Mobil from its 10% stock interest in Aramco as apportionable income.[5]

This standard requires a review of the operational ties between the taxpayer and the minority-owned affiliate. A taxpayer's unitary business can benefit from the affiliate in an operational manner in many ways, including intercompany transactions, shared technology, personnel transfers, and joint purchases and sales. These operational relationships indicate that a "flow of value" exists between the taxpayer and the affiliate. *Container*, 463 U.S. at 176. Importantly, taxpayers and taxing authorities can identify these relationships using objective manifestations. The Court should revise the *ASARCO* and

---

[4] This standard is consistent with the UDITPA definition of business income, which is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." UDITPA § 1(a), 7A Uniform Laws Annotated at 336.

[5] The dissenting opinion in *ASARCO* suggests this standard in Part II.C. *ASARCO*, 458 U.S. at 340 (O'Connor, J., dissenting).

Woolworth decisions to clarify that due process standards are met only when an item of income has an operational, unitary relationship with the activity conducted by a taxpayer engaged in business in a taxing state.[6]

II. The Court Should Reject Any Rule Treating All Income as Apportionable.

During oral argument New Jersey asserted that all of the income of a single corporation should be treated as apportionable income. The New Jersey rule of apportionability runs afoul of the Court's decision in *Mobil,* where the Court determined that a state can only tax an item of income under the Due Process Clause if the income is related to the business activities of the taxpayer in the taxing state. *Mobil,* 445 U.S. at 437. In addition, adopting New Jersey's approach would create a number of significant problems.

---

[6] The dissenting opinion in *ASARCO* suggests that dividend income should be apportionable even in the absence of an operational relationship between the dividend payor and recipient. 458 U.S. at 335 (Part II.A of the dissent) and 337 (Part II.B of the dissent). Other than in the working capital context, the standard of apportionability should depend on the existence of operational ties. Any lesser standard becomes nebulous and difficult to prove, and therefore leads to recurring disputes.

A. Treating All Income as Apportionable Strains the Due Process Requirement of Fair Apportionment.

Overruling *ASARCO, Woolworth* and *Mobil* would not end due process disputes in state taxation. The Due Process Clause requires a rational relationship between the income attributed to a state and the intrastate values of the corporation, or fair apportionment. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978). The factors used in the apportionment formula must reflect in a reasonable sense how the taxpayer generated income. *Container*, 463 U.S. at 169. The New Jersey rule of apportionability would merely shift the constitutional dispute from the apportionability of an item of income to fair apportionment.[7]

If all income is apportionable, taxpayers and taxing authorities will dispute whether the amount of nonbusiness income (such as unrelated investment income) apportioned to a state bears a rational relationship to the intrastate values of the corporation. A brief review of the current apportionment schemes employed by the states will illustrate the problem.

The most common apportionment formula, the three-factor formula, was designed to apportion the income of manufacturing and merchandising businesses. *See* Jerome

---

[7] The apportionability of income cases typically involve whether a state has jurisdiction to tax an item of income earned by a taxpayer not domiciled in the taxing state. *See, e.g., ASARCO* and *Mobil, supra*. Fair apportionment cases typically involve an apportionment formula that arguably attributes too much income to the taxing state. *See, e.g., Moorman, supra*.

Hellerstein, 1 *State Taxation* ¶8.6 (1983). The formula was not designed to apportion nonbusiness income, because that income was typically allocated in whole to the state of domicile.[8] For these reasons, the standard three-factor formula is ill-equipped to handle adequately the apportioning of nonbusiness income.

UDITPA recognizes that fair apportionment is made more difficult when a corporation conducts multiple diverse businesses (as opposed to a single unitary business). UDITPA establishes separate pools of income for apportionment purposes when a corporation or an affiliated group engages in multiple diverse businesses.[9] UDITPA also establishes separate pools of income when a taxpayer engages in a financial and a merchandising business because the income-producing characteristics of these two activities vary significantly.[10] The New Jersey

7

[8] *See* R. Crawford and R. Uzes, *supra*, at ¶505. The UDITPA model apportions income by way of the three-factor formula and allocates investment income to a particular situs state.

[9] *See* Multistate Tax Commission Regulation IV.1.(b) (Two or More Businesses of a Single Taxpayer). The Multistate Tax Commission adopts uniform regulations interpreting UDITPA under the authority of Article VII of the Multistate Tax Compact.

[10] *See* UDITPA § 2, 7A Uniform Laws Annotated at 340.

approach of full apportionment is limited conceptually, however, to a single apportionment formula.[11] The New Jersey approach reaches irrational results, therefore, in instances in which a single apportionment formula is inadequate under UDITPA.

Separate return states that do not employ the three-factor formula will encounter even more difficult fair apportionment problems. The Iowa single-receipts factor approved by this Court in *Moorman* would likely result in *per se* violations of the Due Process Clause if used to apportion nonbusiness income. No rational relationship would exist between the nonbusiness income attributed to the state and the market provided by the state for the taxpayer's products.

Requiring a minimum connection between an item of income and the taxpayer's activities within the taxing state prevents the fair apportionment problems discussed above. As illustrated by the *Moorman* case, sound policy reasons support retention of the standard of apportionability articulated by the Court in the *Mobil* decision.

---

[11] A multiple apportionment formula system attempts to measure the contribution a state makes to each diverse business activity engaged in by a taxpayer. If the state does not make a contribution to one of the business activities (the apportionment formula is zero), the state does not tax any of the income related to that business. Under the New Jersey approach, however, New Jersey apportions all of the income of a taxpayer with one apportionment formula without reference to the location of any given business. New Jersey simply defines all activities of a corporation as a single unitary business. (Tr. at 31.)

B. The New Jersey Rule of Apportionability Would Compel Taxpayers to Adopt an Inefficient Form of Organization.

The New Jersey approach compels taxpayers to adopt a multicorporate form. To limit the reach of New Jersey and other separate return states, taxpayers will place investments and non-nexus businesses in corporations having no contact with the separate return states. New Jersey's approach would therefore create a shell game involving corporate entities.[12]

C. When the New Jersey Rule of Apportionability Is Applied to Combined Reporting States, the Rule Apportions and Taxes the Nonbusiness Income of Corporations Not Engaged in Business in the Taxing State, Thereby Emasculating the Due Process Clause.

California, like many other states that have adopted UDITPA, requires affiliated corporations engaged in a unitary business to file a combined report. A combined report typically includes the income and apportionment factors of all unitary group members regardless of where they do business. The combined report allocates all nonbusiness investment income generally to the state of commercial domicile of the recipient corporation. The combined report creates separate pools of income for each unitary business; a corporation may be included in more than one pool of income subject to apportionment.

---

[12] For example, Bendix could have avoided the New Jersey tax completely if it had a holding company structure, with one subsidiary operating the business of Bendix and another subsidiary holding the ASARCO investment.

The California income of a unitary group is the amount of combined net income apportioned to California by the combined apportionment formula. California income is then reattributed to and split among those unitary members who are engaged in business in California. Each corporation receiving income through this reattribution process becomes liable separately for the tax on its share of apportioned income. Each corporation will also pay tax on its items of nonbusiness income allocable to California.

The New Jersey approach emasculates the Due Process Clause if the approach allows a combined reporting state to apportion and tax the nonbusiness income of all of the corporations in the unitary group, including the nonbusiness income of corporations not engaged in business in the taxing state. This result contradicts every significant unitary tax case, including *Mobil*, *ASARCO*, *Woolworth*, *Container* and *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980).[13]

Similar to the argument made by New Jersey during oral argument, the combined reporting states that seek to tax the nonbusiness income of non-nexus corporations will likely claim that any unfairness can be remedied through an apportionment formula adjustment. But, in practice, taxpayers find *ad hoc* modifications to apportionment formulas difficult if not impossible to make.

---

[13] States may be compelled to discard the unitary business principle entirely, which would mean that the only options would be either separate returns or a consolidated return concept involving all affiliated (including nonunitary) members.

American General's situation in California illustrates the problem. If the New Jersey approach applied to combined reporting states like California, California would apportion the significant insurance company dividends received by American General Corporation using the apportionment formula of the relatively small mutual fund management business. It would be difficult to fashion an apportionment formula adjustment because there is no rational relationship between the dividends paid out of the earnings and profits of the insurance companies and the California activities of the mutual fund business. Including the insurance companies in the mutual fund combined report would be one option, but a difficult one because California, like other states, taxes insurance companies on gross premiums in lieu of a tax on income. The other options are equally complicated, especially given the size of the American General affiliated group. State courts have struggled greatly and reached different conclusions in similar and less complicated cases.[14]

---

[14] *See Tambrands v. Maine State Tax Assessor*, 595 A.2d 1039 (Me. 1991); *NCR Corp. v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn. 1989); *NCR v. Comptroller*, 544 A.2d 764 (Md. 1988); *AT&T v. Wisconsin Dept. of Rev.*, 422 N.W.2d 629 (Wis. Ct. App. 1988); and *NCR Corporation v. Wisconsin Department of Revenue*, Docket Nos. I-8669 and 87-I-359, Wisconsin Tax Appeals Commission.

III. If the Court Adopts the New Jersey Approach, the Court Must Also Rule That a Domiciliary State Cannot Tax All Unrelated Investment Income; These Changes Should Not Be Made Retroactively.

To adopt the New Jersey approach in this case, the Court will also have to determine that the state of commercial domicile can only tax an apportioned share of a taxpayer's investment income. The Court would create chaos for taxpayers and taxing authorities alike if it failed to decide this issue. Taxpayers would face double taxation, and the states would find it impossible to predict revenues accurately given the prospect of retroactive refunds.

A standard of full apportionability can only be imposed fairly on a prospective basis. A retroactive change would create purely random, unanticipated results for both taxpayers and states, especially since statutes of limitations are not consistent from state to state and taxpayers likely have waivers or extensions in place in some states but not others. If the Court reverses *ASARCO* and *Woolworth* but reaffirms the unitary business principle as suggested above, the need for prospective application is less pressing but still necessary to avoid creating difficulties for taxpayers and taxing authorities in those states that have adhered to a literal interpretation of *ASARCO* and *Woolworth*.

CONCLUSION

For the reasons discussed above, the Court should adopt a rule of apportionability that would allow a state to tax income related to an intangible asset only if the asset constitutes an integral part of the taxpayer's unitary business. The Court should reject New Jersey's proposal to empower a state to apportion and tax the entire net income of a corporation.

April 1992

Respectfully submitted,

ROY E. CRAWFORD
Counsel of Record
RUSSELL D. UZES
CHRISTINE A. DEATON
Brobeck, Phleger & Harrison
One Market Plaza
Spear Street Tower
San Francisco, CA 94105
(415) 442-0900

KAREN A. BAIN
American General Corporation
2929 Allen Parkway
Houston, TX 77019

Counsel for Amicus Curiae